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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-727

FINLEY, KUMBLE, WAGNER, HEINE, UNDERBERG & GRUTMAN, a Partnership (formerly known as Finley, Kumble, Underberg, Persky & Roth and Finley, Kumble, Heine, Underberg & Grutman),

Petitioner,

against

CHARLES GROSS, MABEL BLEICH, GROSS & Co., and JEANNE DONOGHUE,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner, Finley, Kumble, Wagner, Heine, Underberg & Grutman ("Finley, Kumble"), additional defendant on counterclaims-appellant-cross-appellee below, requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on August 24, 1977.

Opinions Below

The opinion of the Court of Appeals is not yet reported and appears as Appendix A to this petition. The post-trial opinion of the District Court is not reported and appears as Appendix B to this petition. The pre-trial opinion of the District Court is reported at 365 F. Supp. 1364 and appears as Appendix C to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on August 24, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Questions Presented

This case raises important and recurring questions concerning the scope of federal ancillary jurisdiction.

The decision below extended the reach of ancillary jurisdiction by an expansionary interpretation of the compulsory counterclaim rule. As a result of that interpretation, the courts below were embroiled for six years in litigation of non-federal claims involving non-diverse parties. As a further result of that interpretation, petitioner, who was a stranger to the action when it began, was brought into federal court to answer state law counterclaims which lacked any independent jurisdictional predicate.

Rule 13(a) defines as "compulsory" a counterclaim which "arises out of the transaction or occurrence which is

the subject matter of the opposing party's claim." A counterclaim meeting that description must be pleaded or it is thereafter barred. Under the doctrine of ancillary jurisdiction, the federal courts have been held to have power to adjudicate such a counterclaim even if it presents purely state claims and there is no diversity of citizenship among the parties. *United States* v. *Heywood-Robinson Company,* 430 F.2d 1077 (2d Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971); *Aetna Ins. Co.* v. *Chicago R.I.&P.R. Co.,* 229 F.2d 584 (10th Cir. 1956). *See also, Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926).

On the other hand, a counterclaim not meeting the test of Rule 13(a) is deemed to be "permissive." The defendant does not have to plead it, and if pleaded, the Court lacks power to hear it unless the counterclaim itself raises a federal question or involves parties with diverse citizenship. *Sue & Sam Mfg. Co.* v. *B-L-S Constr. Co.,* 538 F.2d 1048 (4th Cir. 1976); *Pipeliners Local Union No. 798, Tulsa Okla.* v. *Ellerd,* 503 F.2d 1193 (10th Cir. 1974); *United States* v. *Heywood-Robinson Company,* 430 F.2d 1077 (2d Cir. 1970), *cert. denied,* 400 U.S. 1021 (1971).

Here, the Second Circuit adopted a construction of Rule 13(a) which ignores the language and undermines the purpose of the rule, and removes virtually all restrictions on the federal courts' ancillary jurisdiction. The Court did not rely on any temporal, evidentiary, factual or legal relationship between the issues in the complaint and those in the counterclaims. There was no such relationship. Instead, it found a sufficient jurisdictional basis, for purposes of Rule 13(a), in a linkage between the counterclaims and certain defenses which defendants themselves pleaded in

the answer. On that basis, it sanctioned a lengthy federal trial of non-diverse state counterclaims asserted not only against the plaintiff but also against 19 additional third parties who were newly brought into the action.

No other Circuit has held a link between a counterclaim and a defense to be a sufficient nexus for purposes of Rule 13(a). Nothing in the language of the rule speaks of defenses. No policy of judicial economy justifies reaching out for such unrelated state counterclaims, which overwhelmed the simple claims in the complaint and greatly complicated and expanded the litigation below.

The issues presented by this case have a wide impact on the day-to-day functioning of the federal courts. The decision below subjects these courts to new burdens and involves them increasingly in areas constitutionally reserved to the states. There is a need for this Court to speak to these issues, which it has never squarely addressed in the 40 years since Rule 13(a) was adopted.

Insofar as jurisdiction was extended to petitioner and other third parties, this case also presents, in the context of ancillary jurisdiction, the "subtle and complex question with far reaching implications" which this Court grappled with last year in the context of pendent jurisdiction. In *Aldinger* v. *Howard,* 427 U.S. 1 (1976), this Court found limits on the power of federal courts to exercise pendent jurisdiction over third parties not named as defendants to the claim-in-chief. This case is an opportunity to extend the policy of *Aldinger* to actions involving the more frequently invoked doctrine of ancillary jurisdiction.

This petition thus presents the following questions for review:

1. Are non-federal counterclaims "compulsory," regardless of their relation to the plaintiff's claims, simply because they relate to defenses that the defendant chooses to assert in response to those claims?

2. Should the ancillary jurisdiction of the federal courts be extended to non-federal counterclaims, involving non-diverse parties, where the claims and counterclaims involve different issues, different evidence, different time frames, and substantially different parties?

3. Do the federal courts have jurisdiction over non-federal counterclaims, involving non-diverse parties, asserted against third party counterclaim defendants who were strangers to the original action?

Rule Involved

Rule 13(a) and (b) of the Federal Rules of Civil Procedure provides:

RULE 13

COUNTERCLAIM AND CROSS-CLAIM

(a) Compulsory Counterclaims. A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction. But the pleader need not state

the claim if (1) at the time the action was commenced the claim was the subject of another pending action, or (2) the opposing party brought suit upon his claim by attachment or other process by which the court did not acquire jurisdiction to render a personal judgment on that claim, and the pleader is not stating any counterclaim under this Rule 13.

(b) Permissive Counterclaims. A pleading may state as a counterclaim any claim against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim.

Statement of the Case

A. The Claim

This action began in 1971 as a very simple federal case.* It presented, by assignment to plaintiff, the claims of Charles and Mary Buckley, former customers of the brokerage firm of Charles Gross & Co. The complaint alleged that the brokerage firm, in the period 1962-1966, encouraged or permitted excessive trading in the Buckleys' accounts. (A. 15a)** This improper practice, designed to generate unconscionable commissions, is commonly called "churning."

Churning violates the federal securities laws.† The complaint asserted those federal claims and, based on the

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* Jurisdiction was predicated on 15 U.S.C. §77(v)(a) and 15 U.S.C. §78(a) (1970) and the doctrine of pendent jurisdiction.

** Citations refer to the appendices found at the conclusion of this Petition.

† Churning has been held to violate the Securities Exchange Act of 1934 and Rule 10(b)(5) for which a private cause of action will lie. *See e.g.*, Ruskay v. Waddel, 552 F.2d 392, 393 n.2 (2d Cir. 1977); Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975).

identical allegations, a claim of common law fraud. Named as defendants were the brokerage firm; its general partner, Charles Gross; and a limited partner, Mabel Bleich. Suing as plaintiff was Newburger, Loeb & Co., Inc. ("the Corporation"), which acquired the Buckley claim by assignment in 1971.

The complaint thus raised narrow issues frequently litigated in federal court under the securities laws: What was the nature and extent of trading in the Buckleys' accounts in 1962-1966? Who effectively exercised control over the accounts—the dealer or the customer? Who initiated the various transactions in the accounts? Was the customer sufficiently sophisticated to evaluate the broker's advice? So narrow and commonplace were these questions that the Court of Appeals devoted barely three pages of its 50-page printed opinion to disposing of them.

B. The Counterclaims

It was the responsive pleadings which transmuted this simple federal case, involving four parties, into a cumbersome, protracted litigation of more than a dozen state claims involving two dozen non-diverse parties—most of whom had nothing to do with the original dispute. Defendants Gross and Bleich—and their colleague, one Jeanne Donoghue—were engaged in a totally unrelated controversy with various individuals and entities connected with Newburger, Loeb & Co. ("the Partnership"), assignor of the Buckley claims to the Corporation. They seized on the Buckley churning complaint as a vehicle for bringing this state law controversy into federal court.

The controversy arose out of the severe economic woes which afflicted the Partnership, a Wall Street investment

and brokerage firm, during the "back office crunch" in the stock market in 1970. Gross had been a general partner—indeed, the managing partner—of the Partnership. However, the firm did not prosper under his direction, and he withdrew. In the relevant period, he was a "withdrawn general partner" whose capital remained at risk with the firm for one year. Bleich and Donoghue were limited partners. (A. 6a-7a)

In late 1970, the New York Stock Exchange threatened the Partnership with immediate suspension unless its impaired capital condition was corrected. The most significant step taken by the Partnership to solve its financial problem was the proposed reorganization of the Partnership into a new Corporation, a step which would (and did) attract new capital. (A. 8a)

Gross and his allies, Bleich and Donoghue, ("the Gross faction") opposed this transaction; everyone else supported it. In the ensuing hard bargaining, it was found below, the Gross faction was threatened and pressured in an effort to compel its consent. A principal element of this effort, it was found below, was the threat to bring "baseless" litigation against the Gross faction—including the Buckley claims, which the Partnership acquired in 1970. The effort failed; the Gross faction witheld consent. (A. 8a-9a)

Nevertheless, the transaction went forward and was closed on February 11, 1971. The Partnership's assets, including the Gross faction's capital, were transferred to the Corporation. Among the many assets transferred at the same time was the Buckley claim. The Gross faction

contended that these actions constituted a common law conspiracy to injure them, a breach of fiduciary duty, and a violation of New York Partnership Law §98.* (A. 15a-16a)

This controversy, of course, had nothing to do with the issue of whether unlawful churning occurred in the Buckleys' accounts in 1962-66. The controversy did not raise federal questions. Nor was there diversity of citizenship among the parties to the controversy. Nevertheless, this controversy became the centerpiece of the litigation below, totally engulfing the Corporation's simple churning claims.

The controversy was propelled into federal court by the following procedural maneuvers:

First: Donoghue, who was not a party to the churning claims pleaded in the complaint, thrust herself into the action as a volunteer defendant. That enabled her to counterclaim.

Second: Gross, Bleich and Donoghue alleged, as defenses to the complaint, that the very acquisition of the Buckley claim and its assertion in this lawsuit were tortious, and that the assignment of the claim to the Corporation—as part of the 1971 reorganization—was unlawful.**

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* As construed below, this state statute precluded the reorganization in the absence of consent by Bleich and Donoghue. Gross, as a withdrawn general partner, had no standing to block the transaction. (A.36a-38a)

** The Second Circuit described the defenses as follows:

> Essentially, the defendants asserted two defenses to the Corporation's churning claims. First, they contended that the February 11 transfer, which included the transfer of the Buckley claim from the Partnership to the Corporation, was ineffective because conducted in violation of New York Partnership Law §98; ac-

(footnote continued on next page)

Third: Gross, Bleich and Donoghue asserted 8 state law counterclaims dealing with the 1971 reorganization and its aftermath.*

Fourth: These counterclaims were asserted against not only the plaintiff Corporation but also 16 parties who were strangers to the case-in-chief. These newly added parties were designated as "additional defendants on counterclaims."

Fifth: Nine months later, in an amended answer, the Gross faction asserted these same counterclaims against three additional strangers—petitioner Finley, Kumble, a law firm which served as counsel to the Corporation, its partner in charge of the matter, and the house counsel to the Partnership. Finley, Kumble ultimately became the principal target of the counterclaimants, the focus of the

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cordingly, they contended that the Corporation could not press the Buckley claim because it did not own it. Second, the defendants claimed that the Corporation was estopped from asserting the claim because it was brought as part of a conspiracy against them in violation of the fiduciary duties owed to them; thus, the defendants alleged, *inter alia*, that the Buckley claim was taken by the Partnership in bad faith for the sole purpose of creating a colorable claim against them, that the transfer of assets was induced by "fraudulent special consideration" as part of a plot by Kayne, Muh and Risher to gain control of the Partnership's assets, and that the transfer itself was a violation of fiduciary duty. (A. 29a)

* Buried in the voluminous pleadings in this case was a final counterclaim—the ninth—purporting to assert a violation of the federal antitrust laws on behalf only of Gross. So devoid of substance was this counterclaim that the District Court dismissed it in a footnote (C. 77a, n.33); the Court of Appeals affirmed, finding "no support in the record for Gross' claim." Neither lower court regarded this claim as a basis for federal pendent jurisdiction over the other counterclaims because the common nucleus of operative fact required by *Gibbs* v. *United Mine Workers*, 383 U.S. 715 (1966) was lacking. (A. 33a)

District Court's opinion, and the source of funds to which the Gross faction looked to satisfy the judgment.

Sixth: The plaintiff Corporation, asserted what can only be characterized as "counter-counterclaims" against Gross. These six new state law claims related neither to the churning of the Buckleys' accounts in 1962-66 nor to the reorganization of 1971; rather, they dealt with alleged misfeasance by Gross during his tenure as managing partner of the Partnership in 1970. (A. 15a-17a; B. 58a-59a)

C. Trial and Decisions on the Merits

The case was tried before the United States District Court for the Southern District of New York in 1975. The trial consumed six weeks of court time and generated a record exceeding 6,000 pages, the great bulk thereof devoted to the counterclaims. Although much of the trial was conducted before a jury, the jury became "restive" as the proceedings droned on; ultimately it was excused, and the case was decided by the Court. (B. 57a)

After a year of deliberation, the District Court rendered its opinion. Quickly rejecting the churning claims, the court devoted its major attention to the counterclaims. It found violations of New York law with respect to three of them.* (B. 71a) Accordingly, it entered judgment against the plaintiff Corporation and 17 of the additional defendants on the counterclaims, including petitioner. With interest and costs, the judgment came to approximately $1,000,000.

* Five of the nine counterclaims had been dismissed before trial, and one was rejected in the District Court's post-trial decision.

On appeal, the Second Circuit affirmed with respect to the three non-federal counterclaims. In doing so, it concededly resolved a novel question of New York law: the scope of fiduciary obligations under the New York Partnership Laws. (A. 48a) By rejecting petitioner's contention that it could not be held liable to defendants for acts in its role as counsel to the plaintiff, the Court necessarily decided a further novel question of New York law. (A. 48a-49a) The Court, however, reversed approximately 25% of the judgment and remanded the balance of the case to the District Court for a redetermination of damages. (A. 50a-52a)*

D. Decision Below on Jurisdictional Issues

The three counterclaims which survived, and to which this petition is addressed, asserted the following: (a) the reorganization violated N.Y. Partnership Law §98 because it was consummated without the consent of Bleich and Donoghue; (b) the transfer of assets to the Corporation was a breach of fiduciary obligation; and (c) the events of 1970 and 1971 leading up to the reorganization constituted a conspiracy to injure the Gross faction and force their consent to the reorganization. (A. 15a-16a)

As the lower courts recognized, these counterclaims did not involve federal questions and there was no diversity of citizenship among the parties, most of whom were residents of New York. Thus, there was jurisdiction over these counterclaims only if they were compulsory under Rule 13(a) and within the Court's ancillary jurisdiction. (A.

* The District Court declined to stay further proceedings on damages pending this petition, and those proceedings have gone forward.

17a, 26a-27a) The key to the jurisdictional issue, therefore, was whether the counterclaims "arose out of the same transaction or occurrence" as the Corporation's churning claim and were covered by Rule 13(a).*

The Second Circuit held that the counterclaims were compulsory not because of their relationship to plaintiff's churning claims but because of their relationship to purported defenses to those claims. (A. 26a-27a) The Second Circuit reached this result even though (i) the Rule's language says nothing about defenses; (ii) the defenses in question—that the assignment and assertion of the Buckley claim were unlawful and tortious—dealt with unrelated matters occurring four years after the churning of the Buckley accounts; and (iii) the defensive allegations—although sustained—were treated by the trial and appellate courts only as grounds for affirmative counterclaim relief and not as grounds for defeating the complaint's churning claim.

In short, the defenses were not covered by Rule 13(a), were not related to the claims asserted in the complaint, and were not treated as true defenses. They were simply the vehicle for asserting state law counterclaims against non-diverse parties and strangers to the original action.

In holding that a link between defenses and counterclaims is sufficient to render the counterclaims compulsory, and in reaching out for state counterclaims so remotely connected to the complaint, the Second Circuit significantly

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* Petitioners raised the issue of subject matter jurisdiction by pre-trial motion and on appeal.

expanded the scope of federal jurisdiction and, we submit, committed fundamental error.

Moreover, the Court paid scant attention to the problems created by applying this expansionary jurisdictional doctrine to third parties—parties who had no connection with the case when it was commenced. The Court said in passing that:

> "... further, if a counterclaim is compulsory, the district court's ancillary jurisdiction extends to third parties (in this case the additional defendants) whose presence is required for adjudication of the counterclaim. See *Moor* v. *County of Alameda,* supra, 411 U.S. at 714-15; *United Artists Corp.* v. *Masterpiece Productions,* supra, 221 F.2d at 216-17." (A. 27a)

However, *Moor* was a pendent jurisdiction case and is not authority for this proposition (*supra* at 31). And there is serious doubt as to the vitality of the Second Circuit's own decision in *United Artists,* along with other prior case law, in light of the concern about extending federal jurisdiction to third parties expressed by this Court last year in *Aldinger* v. *Howard,* 427 U.S. 1 (1976). The Second Circuit did not consider the application of *Aldinger* to this issue.

Reasons for Allowance of the Writ

I

Review is needed to correct a misinterpretation of Rule 13(a)—unique to the Second Circuit—which would significantly expand the jurisdiction of federal courts and improperly involve them in litigation of non-diverse state claims.

The conclusion below that defendants were required to assert numerous, unwieldy state claims in response to plaintiff's simple, unrelated churning claims stretches Rule 13(a) to the breaking point. The conclusion that Rule 13(a) embraces counterclaims related to defenses—regardless of their relationship to the complaint—conflicts with the language and frustrates the policy of the Rule. No court has ever so held—except the Second Circuit itself in its previous decision in *Lesnick* v. *Public Industries Corporation,* 144 F.2d 968 (2d Cir. 1944).

On the basis of this novel holding, the District Court was encumbered for several weeks in a trial of purely state claims which, but for this holding, it was powerless to hear, It spent a full year sorting out the rights and liabilities, under state law, of some 24 non-diverse litigants, the vast majority of whom were strangers to the narrow federal controversy before it. The Court of Appeals sanctioned this expenditure of federal judicial resources.

The implications of this holding are obvious and sobering: in the name of judicial economy, already overburdened federal courts will further intrude into areas reserved to the states and become increasingly bogged down

in the litigation of disputes which belong elsewhere. Review is needed to curb this unwarranted expansion of federal jurisdiction and to clarify the compulsory counterclaim doctrine which, despite its importance in the day-to-day workings of the lower courts, has not been squarely addressed by this Court since Rule 13(a) was adopted.

A. The Second Circuit has misinterpreted and significantly expanded Rule 13(a).

In applying the language of Rule 13(a), courts normally determine whether the complaint and counterclaims involve substantially the same time frame, evidence, factual setting, legal issues and the like, and whether adjudication of the complaint would be *res judicata* as to the counterclaims. As the Tenth Circuit said in *Pipeliners Local Union No. 798, Tulsa, Okla.* v. *Ellerd,* 503 F.2d 1193, 1198 (10th Cir. 1974):

> "It has been said that most courts, rather than attempting to define the key terms of Rule 13(a) . . . precisely, have preferred to suggest standards by which the compulsory or permissive nature of specific counterclaims may be determined: (1) Are the issues of fact and law raised by the claim and counterclaim largely the same? (2) Would res judicata bar a subsequent suit on defendants' claim absent a compulsory counterclaim rule? (3) Will substantially the same evidence support or refute plaintiffs' claims as well as defendants' counterclaim? and (4) Is there any logical relation between the claim and the counterclaim? See Wright and Miller, Federal Practice and Procedure, Civil §1410, Ch. 4, p. 42 and cases cited. . . ."

These criteria have been cited with approval by courts in other Circuits. *Sue & Sam Mfg. Co.* v. *B-L-S Constr. Co.,*

538 F.2d 1048 (4th Cir. 1976); *Agostine* v. *Sidcon Corp.*, 69 F.R.D. 437 (E.D. Pa. 1975). Even where the Tenth Circuit's formulation is not explicitly invoked, other circuits normally treat these criteria as central to an application of Rule 13(a). *Columbia Plaza Corp.* v. *Security Nat. Bank*, 525 F.2d 620 (D.C. Cir. 1975); *Albright* v. *Gates*, 362 F.2d 928 (9th Cir. 1966); *Great Lakes Rubber Corp.* v. *Herbert Cooper Co.*, 286 F.2d 631, 634 (3d Cir. 1961).

None of these criteria suggests the slightest relationship between the claims and counterclaims asserted here.

First, the issues of fact and law raised by the complaint and the counterclaims are totally disparate. Plaintiff's claims involve the alleged churning by Gross & Co. of the Buckleys' brokerage accounts from April 1962 through August 1966. The claims have nothing to do with the Newburger, Loeb reorganization or any events after 1966, including the assignment of that claim to the Corporation in 1971 or its subsequent assertion by the Corporation.

On the other hand, the counterclaims relate to the transfer of assets, on February 11, 1971, of the Partnership to the Corporation, and the defendants' opposition to that transfer. They concern alleged torts and violations of the N.Y. Partnership Law occurring several years after any transactions which are the subject of the complaint. These issues have nothing whatsoever to do with any events in 1962 through 1966, let alone the events relating to the Buckleys' brokerage accounts. The defenses—that the acquisition and assertion of the Buckley claims in 1971 were unlawful and tortious—do not bear on "the subject matter of [plaintiff's] claim."

Second, a disposition of the complaint would not be *res judicata* of the counterclaims, and vice versa. Nothing illustrates that more clearly than the lower court decisions in this very case. Both the District Court and the Second Circuit rejected the churning claims on the merits, without any reference to the counterclaims. Likewise, in adjudicating the counterclaims, neither court relied on or even mentioned a single finding of fact or conclusion of law used to adjudicate the churning claims. In essence, both the trial and appellate courts issued two separate opinions linked only by the caption.

Third, the evidence on the complaint and the counterclaims was completely different. Just as the decision below was really composed of two decisions, so the trial below was really a succession of two trials—one of the churning claims and the other of defendants' counterclaims. The testimonial and documentary evidence introduced in support of the complaint was not considered on the trial of the counterclaims, and the proof on the counterclaims had no bearing on the claims in the complaint.

But the Second Circuit paid no attention to these matters. Indeed, it made little effort to link the issues in the counterclaims with the issues in the complaint. Instead, it found the counterclaims to be compulsory because of their relationship with the defenses pleaded in the answer.

Thus, although there was no overlap between the claims and the counterclaims, the Second Circuit invoked Rule 13(a) because of "a substantial overlap between the defendants' defenses and their . . . counterclaims." (A. 30a) Although there was no overlapping of proof between the

claims and the counterclaims, the Second Circuit invoked Rule 13(a) because "proof of these defenses was tantamount to establishing defendants' case on their counterclaims." (A. 30a) In sum, the Second Circuit agreed with the District Court's conclusion

> "that defendants' first and second counterclaims were so closely tied to its defenses to the Corporation's claims that they were 'logically related' to those claims and that since the fourth counterclaim asserted the same allegedly wrongful acts, it too should be considered a compulsory counterclaim." (A. 29a)

and affirmed on that basis.

By holding that a link between a counterclaim and a defense is a sufficient nexus to support federal jurisdiction, the Second Circuit rejected the very language of Rule 13(a). The Rule defines a compulsory counterclaim as one "which . . . arises out of the transaction or occurrence that is the subject matter *of the opposing party's claim* . . ." (emphasis supplied). Rule 13(a) does not speak in terms of defenses, and nothing in its language permits the kind of analysis in which the Second Circuit engaged.

The holding below rejects, as well, the policy and the procedural logic inherent in Rule 13(a). When a plaintiff brings a federally cognizable claim, neither the defendant nor the court has any choice about delving into the transactions and occurrences on which it is based. If those same transactions and occurrences—which must be explored in any event—give rise to a non-federal counterclaim, common sense and the interests of judicial economy suggest that both claims be resolved simultaneously.

But a defendant has complete control over his defenses.* The fertile mind of a pleader can devise wholly extraneous defenses which, regardless of their merit, become the hook on which to hang elaborate state counterclaims raising matters the court otherwise would not and could not hear.

That is precisely what happened in this case. Although the defenses were held to be acceptable vehicles for bringing the counterclaims, and the allegations thereof were sustained for purposes of awarding defendants affirmative relief, the lower courts did not regard the defenses as sufficient to defeat the churning claims. On the contrary, both the District Court and the Second Circuit considered and resolved the churning claims on the merits—without ever mentioning the defenses.

The gist of the defenses was that the Buckley claim could not be asserted because it was assigned to plaintiff as part of an illegal transaction and that the plaintiff's assertion of the claim was tortious.** The lower courts con-

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* For that reason, a counterclaim linked to a defense can never be truly "compulsory" as that word is commonly understood. If the defendant, for tactical or procedural reasons, prefers not to assert his counterclaim, he simply refrains from asserting the defense to which it is linked. He is then free to assert his claim in another action. Thus the Second Circuit's holding inverts the concept of Rule 13(a)—that a defendant must assert compulsory counterclaims or be forever barred—and gives the defendant discretion to assert or not to assert compulsory counterclaims.

** The courts below did not rely on the Gross faction's contention that the Corporation's ritualistic one sentence allegation in the complaint that it owned the churning claims, by assignment, provided common legal and factual issues which compelled the Gross faction to assert its counterclaims.

Moreover, the courts below did not rely on the argument that the counterclaims were compulsory because defendants alleged the very assertion of the churning claim to be part of the conspiracy and

(footnote continued on next page)

cluded that the transaction in which the Buckley claim was assigned to plaintiff was indeed illegal and its assertion indeed tortious. But neither court held or even suggested that this barred the churning claims.

In short, once the defenses opened the door to extensive counterclaims, they were ignored as defenses.

Thus, the holding below undermined the purpose of Rule 13(a). That purpose is to promote judicial economy, prevent duplication, and avoid unnecessary burdens on the courts and the parties. *Southern Constr. Co., Inc.* v. *Pickard,* 371 U.S. 57 (1962). As the Second Circuit itself said:

> "Since a compulsory counterclaim is by definition closely related to the subject matter of the opposing party's claim, common sense and judicial economy compel the conclusion that such claims should be tried together and the extension of ancillary jurisdiction to compulsory counterclaims is consistent with Article III's grant of jurisdiction over 'cases' arising under the Constitution and federal laws." (A. 28a)

But here, rather than efficiently adjudicating related claims at the same time, the court was burdened with two totally disparate claims. The churning claims were tried (and ultimately resolved) without reference to the matters

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tortious. Lower courts have uniformly held that the assertion of wrongful conduct or improper motive for instituting the main action cannot provide the connection necessary to make a counterclaim compulsory. Solomon v. Bruckhausen, 305 F.2d 941, 943 (2d Cir. 1962), cert. denied, 371 U.S. 351 (1963); *see* 3 Moore's Federal Practice ¶13.13 at 13-308 (2d ed. 1969); 6 Wright & Miller, Federal Practice and Procedure: Civil §1411 at 56 (1969) and cases cited thereunder. Instead, they found a "logical relationship" between the churning claim and the counterclaims because "there was a substantial overlap between the defendants' defenses and their . . . counterclaims." (A. 30a)

alleged in the counterclaims. The court then proceeded to conduct what amounted to a second trial of the state counterclaims. The effect of the holding below was to complicate, not to simplify, litigation.

The Second Circuit's expansive interpretation of Rule 13(a) unduly complicates federal litigation for yet another reason. A counterclaim covered by Rule 13(a) is, of course, compulsory by definition. The Rule, as written, requires a litigant to examine the complaint and determine whether he has any claim closely connected thereto. Any such claim must be asserted, or it is thereafter barred.

Under the holding in this case, a further requirement is imposed on the litigant. He must now examine his defenses and assert all claims related to those defenses, lest they be barred. Indeed, if a counterclaim is compulsory and must be asserted, but can be asserted only by linkage to a defense, is not the defense also compulsory? The uncertainty resulting from the Second Circuit's holding will inevitably cause litigants to resolve doubts in favor of asserting all conceivable defenses and counterclaims.

B. The holding below is unique to the Second Circuit.

In creating this burdensome legacy for the federal courts, the Second Circuit went beyond existing case law. Although, as elaborated below (*infra* at 26), all courts tend to be expansive in applying Rule 13(a), the Second Circuit's holding has extended the outermost limits of this trend. The Second Circuit cited only one other decision which held a counterclaim to be compulsory because of its link to a defense: *Lesnick* v. *Public Industries Corporation*,

144 F.2d 968 (2d Cir. 1944) decided by the Second Circuit itself.

In analogous situations, this Court and the lower courts have rejected any attempt to predicate federal jurisdiction on a defense.

Thus, in *Louisville & Nashville R.R.* v. *Motley*, 211 U.S. 149 (1908), this Court expressly held that a defense was not a basis for federal question jurisdiction. In *Motley*, plaintiffs brought an action in federal court for specific performance of a contract—a state claim. The complaint alleged that defendant based its refusal to perform on an Act of Congress, but plaintiff contended the federal statute either did not justify non-performance in these circumstances or was unconstitutional. This Court noted that any justification for non-performance was a defense, not part of the claim itself. The Court concluded that federal jurisdiction can be established only on the basis of a party's statement of his own claim, not on the basis of federal questions in an anticipated defense to that claim:

> "[*A*] *suit arises under the Constitution and laws of the United States only when the plaintiff's statement of his own cause of action shows that it is based upon those laws or that Constitution.* It is not enough that the plaintiff alleges some anticipated defense to his cause of action, and asserts that the defense is invalidated by some provision of the Constitution of the United States." *Id.* at 152 (emphasis added).

The complaint was dismissed for lack of jurisdiction.

Applying that doctrine, this Court has held that, to determine whether there is federal question jurisdiction in a

declaratory judgment action, the federal courts must investigate the rules governing pleading in a hypothetical coercive action. This is to ensure that federal jurisdiction is not expanded, in violation of the intent of the Declaratory Judgment Act, where these actions present federal issues—like anticipated defenses—which would not serve as the basis of a federal claim. *Skelly Oil Co.* v. *Phillips Petroleum Co.*, 339 U.S. 667 (1950).

The Second Circuit's decision undermines this principle. Jurisdiction can be founded on "the subject matter of an opposing party's claim" only if a party's counterclaim rests not on a defense he pleads to the opposing party's complaint, but on the actual substantive legal and factual issues asserted in the opposing party's complaint.

Indeed, the Second Circuit may be poised on the brink of eliminating all remaining restraints on ancillary jurisdiction. Judge Friendly has concluded that a defendant in federal court should be permitted to assert any state counterclaim he has against the plaintiff—even if there is no independent basis for federal jurisdiction over the counterclaim and it has no relationship to the complaint. *United States* v. *Heyward Robinson Co.*, 430 F.2d 1077 (2d Cir. 1970) (Friendly, J. concurring), *cert. denied*, 400 U.S. 1021 (1971). Several commentators have also adopted this view. 3 J.W. Moore, *Federal Practice*, ¶13.19[1] at 13, 483-88 (2d ed. 1974); G.B. Fraser, *Ancillary Jurisdiction and the Joinder of Claims in the Federal Courts*, 33 F.R.D. 27 (1963); T.S. Green, Jr., *Federal Jurisdiction Over Counterclaims*, 48 N.W.U.L. Rev. 271, 278-80 (1953); J.E. Kennedy, *Counterclaims Under Rule 13*, 11 Houston L. Rev. 255, 266 (1974).

In its decision below, the Second Circuit indicated that it was interested in this concept, and the court "refrained" from exploring it only because the parties "did not ask" it to do so. (A. 27a, n.19) Inevitably, parties *will* ask the court to do so, and the Second Circuit may embrace this doctrine. Alternatively, it may achieve the same practical effect—eliminating all restrictions on ancillary jurisdiction—by enlarging the coverage of Rule 13(a) until the distinction between permissive and compulsory counterclaims becomes meaningless. It moved another step in that direction in this case.

C. There is a need for this Court to construe Rule 13(a) after 40 years of lower court experimentation.

Such expansion of Rule 13(a), spearheaded by the Second Circuit, appears inevitable in the absence of any guidance from this Court. The Federal Rules of Civil Procedure were adopted in 1938. In the ensuing 40 years, this Court has never construed the "transaction or occurrence" language of Rule 13(a). It has never issued guidelines, discussed relevant criteria, or probed the outer limits of the compulsory counterclaim doctrine.

Only twice has the Court even addressed Rule 13(a). On each occasion, it held that the counterclaim under consideration was not compulsory—on grounds not here relevant. See *Southern Construction Company, Inc.* v. *Pickard*, 371 U.S. 57 (1962); and *Mercoid Corp.* v. *Mid-Continental Co.*, 320 U.S. 661 (1944). Nothing in either holding suggests the expansive reading adopted below. But neither of these cases—or any other Supreme Court case—promulgates standards for the application of Rule 13(a).

In the absence of any Supreme Court interpretation of Rule 13(a), the lower courts have reached back to its predecessor—Equity Rule 30—adopted in 1912. They have sought guidance from this Court's discussion of Equity Rule 30 in *Moore* v. *New York Cotton Exchange*, 270 U.S. 593 (1926). In its decision below, the Second Circuit ritualistically invoked the following language used by this Court fifty years ago in *Moore*:

> " 'Transaction' [as used in Equity Rule 30] is a word of flexible meaning. It may comprehend a series of many occurrences, depending not so much upon the immediateness of their connection as upon their logical relationship." (A. 28a, n.20)

Fifty years is a long time. Federal litigation is far more complex, federal and state claims far more diverse, and federal courts far more heavily burdened than a half-century ago. Surely, after fifty years, it is time to take another look at the very general language of *Moore* and the very expansive rulings which have been promulgated in its name.

One thing is very clear: Lacking specific guidance from this Court, and invoking the general language of *Moore* for legitimacy, the lower courts have read Rule 13(a) very expansively indeed. We have noted above that the Second Circuit is a trail blazer in this effort. But we readily acknowledge that other Circuits have utilized Rule 13(a) to extend their subject matter jurisdiction. As the District Court below stated, there is a "general trend toward expansion of the concept of compulsory counterclaims." (C. 83a)

As a result, the federal courts are increasingly open to litigants asserting non-diverse state claims, and federal actions are increasingly expanded by counterclaims that belong in the state courts. Review of the decision below will give this Court an opportunity to restore some vitality to Rule 13(a) and provide guidance for its application. After 50 years, we respectfully submit, such guidance is urgently needed.

D. The decision below will impose new burdens on the federal courts and increasingly involve them in areas reserved to the states.

Absent such guidance, the decision below has significant —and unfortunate—implications for the federal courts.

Its holding that even marginally related counterclaims are compulsory brings into the sweep of federal ancillary jurisdiction state claims which have little or no bearing on any case properly in federal court and which otherwise could not be heard there. In view of the large number of cases in which litigants have opposing claims against another party, the volume of state claims the federal courts would have to adjudicate under this ruling would be substantial.

The extension of ancillary jurisdiction under such a broad reading of the Rule conflicts with the Rules Enabling Act, 28 U.S.C. §2072 (1970), and Fed. R. Civ. Proc. 82, which prohibit the Federal Rules from expanding the scope of federal jurisdiction. More importantly, the decision contravenes federal constitutional and statutory policies carefully limiting federal jurisdiction.

The federal courts do not, of course, have general jurisdiction over state or even federal claims; their power is limited by the Constitution and by statute. This Court has long recognized that the scope of federal jurisdiction must be construed in light of the Constitutional and statutory policies underlying these limitations. *Indianapolis* v. *Chase National Bank,* 314 U.S. 63, 76 (1941) (Frankfurter, J); *see also Skelly Oil Co.* v. *Phillips Petroleum Co.,* 339 U.S. 667 (1950). For example, this Court has strictly construed the minimum amount in controversy requirement in light of Congressional intent to diminish the federal caseload. *Zahn* v. *International Paper Co.,* 414 U.S. 291 (1973).

In particular, this Court has a long standing policy limiting unnecessary determination of state law issues in the federal courts when they are not bound up with federal issues and can be referred to the state courts. Thus, its policy is to construe the diversity statute strictly in light of the Congressional intent to "jealously restrict" federal jurisdiction over state claims to "relieve the federal courts of the overwhelming burden of business that intrinsically belongs in the state courts in order to keep them free for their distinctive business," and to foster Constitutional policies "of avoiding offense to state sensitiveness." *Indianapolis* v. *Chase National Bank,* 314 U.S. at 76. Moreover, this Court has evolved an elaborate doctrine of abstention to avoid interfering with the states' autonomy by unnecessary federal consideration of novel state law issues. *See, e.g., Rizzo* v. *Goode,* 425 U.S. 993 (1976).

Review of the decision below is needed to reconcile the concept of ancillary jurisdiction with these fundamental

Constitutional and statutory policies. The expansion of ancillary jurisdiction envisioned by the Second Circuit would disturb the balance between federal and state courts. It would divert from the state to the federal courts a large body of state cases on a compulsory basis. It would require the federal courts to confront unsettled questions of state law, and impede the state courts in exercising their proper function in our federal system.

Adjudication of these cases would thrust an undesirable and especially laborious burden on the already overburdened federal courts, which cannot speak with their own authority on these issues. In 1969, the Study of the Division of Jurisdiction Between State and Federal Courts concluded that it was "intolerable" that the constant and growing pressures of state law cases paralyzed the federal courts from exercising their proper role of adjudicating federal claims. American Law Institute, *Study of the Division of Jurisdiction Between State and Federal Courts* (1969) at 1. It concluded that the proper place for most state claims is in the state courts.

This conclusion speaks with a special urgency today in view of the continually expanding workload of the federal courts and the pressures of the Speedy Trial Act. At an ever-growing pace, the federal caseload has risen dramatically because of the increased complexity of society and the expansion of federal law. From 1960 to 1975, the federal caseload grew by more than 106 percent, and it continues to rise. R.H. Bork, *Dealing with the Overload in Article III Courts*, 70 F.R.D. 231 (1976). This case presents the Court with an opportunity to restrain that trend.

II

Review is needed to apply, in the area of ancillary jurisdiction over counterclaims, the cautionary policy articulated in this Court's opinion in *Aldinger* v. *Howard*.

In *Moor* v. *County of Alameda*, 411 U.S. 693, 715 (1973), *Philbrook* v. *Glodgett*, 421 U.S. 707 (1975) and *Aldinger* v. *Howard*, 427 U.S. 1 (1976), this Court confronted what it termed a "subtle and complex question with far reaching implications": whether pendent jurisdiction can be asserted over a third party as to whom there is no independent basis of federal jurisdiction. This case sharply presents the same recurring issue in the context of ancillary jurisdiction. Petitioners submit that the courts below erred in exercising jurisdiction over 19 counterclaim defendants who were total strangers to this litigation and for whom there was no independent basis of federal jurisdiction.

Ancillary jurisdiction, like pendent jurisdiction, is a court-fashioned doctrine founded on the principles of judicial convenience, economy and efficiency. *Cf. United Mine Workers* v. *Gibbs*, 383 U.S. 715 (1966) with *Moore* v. *New York Cotton Exchange*, 270 U.S. 593 (1926). Like pendent jurisdiction, ancillary jurisdiction enables the federal courts to avoid piecemeal litigation and to afford complete relief to the parties. The same considerations of the Constitutional and practical limitations on the federal courts should be applicable to both doctrines, and they should be treated the same for the purposes of determining jurisdiction. W.D. Claster, *Pendent and Ancillary Jurisdic-*

tion: *Twards A Synthesis of Two Doctrines,* 22 U.C.L.A. L. Rev. 1263 (1975).

In *Moor,* this Court faced the question of whether, in a federal civil rights suit brought against a county's police officers, a federal court could exercise pendent jurisdiction over a state claim against the county, which was a stranger to the federal claim. The Court concluded that it was not necessary to decide the issue on jurisdictional grounds. It pointed out that pendent jurisdiction rests not only on the power but also on the discretion of the federal courts. This Court affirmed the lower courts' discretionary refusal to hear the claim; it did not reach the question of whether the lower courts actually had power to hear the claim.

Similarly, *Philbrook,* 421 U.S. 707 (1975), presented the question of whether pendent jurisdiction could be applied to third parties, but the Court did not find it necessary to resolve the question because the issue was not briefed and was of no practical significance to the parties.

In *Aldinger* v. *Howard,* 427 U.S. 1 (1976), this Court was presented with the same issue raised by *Moor.* This time, however, the Court concluded that the lower courts did not have pendent jurisdiction over the third party. Although the Court's holding was narrow,* it clearly expressed grave doubts about ever exercising pending jurisdiction over third parties for whom there was no independent basis of federal jurisdiction. The Court concluded:

> "From a purely factual point of view, it is one thing to authorize two parties, already present in federal

*The Court relied on the fact that the Civil Rights Act did not cover county governments. Under those circumstances, it held, Congress could not have intended the federal courts to exercise pendent jurisdiction, based on the same allegations, over state claims asserted against the same county governments.

> court by virtue of a case over which the court has jurisdiction, to litigate in addition to their federal claim a state law claim over which there is no independent basis of federal jurisdiction. But it is quite another thing to permit a plaintiff who has asserted a claim against one defendant with respect to which there is federal jurisdiction, to implead an entirely different defendant on the basis of a state law claim over which there is no independent basis of federal jurisdiction, simply because his claims against the first defendant and his claim against the second defendant 'derive from a common nucleus of operative fact.' " 427 U.S. at 14.

Several lower federal courts, like the courts below, have held that a district court's ancillary jurisdiction extends to additional third parties whose presence is required for adjudication of a compulsory counterclaim. *See e.g., H.L. Peterson Co.* v. *Applewhite,* 383 F.2d 430 (5th Cir. 1967); *Albright* v. *Gates,* 362 F.2d 928 (9th Cir. 1966); *United Artists Corp.* v. *Masterpiece Productions, Inc.,* 221 F.2d 213 (2d Cir. 1955). In *Moor,* this Court noted the existence of these authorities, 411 U.S. at 714-15. It did not deal with them because *Moor* did not involve ancillary jurisdiction. The Second Circuit, in its opinion below, apparently construed the Court's silence as acquiescence. (A. 27a)

We respectfully submit that *Moor* does not stand for this proposition, that this proposition cannot withstand constitutional scrutiny, and that it cannot be squared with this Court's reservations in *Aldinger.* The Federal Rules permit impleading of a third party to a compulsory counterclaim, Fed. R. Civ. Proc. 13(h). However, under *Aldinger's* recognition of the constitutional limitations on federal ju-

risdiction, the federal courts must have an independent basis of jurisdiction to hear the claim asserted against the third party.

This case presents the *Aldinger* issues in a more important context. Whereas pendent jurisdiction claims are asserted only occasionally, the potential for asserting state counterclaims against non-diverse third parties exists in many cases. The potential for abuse is compounded where, as here, the counterclaims asserted have only the most attenuated link to the complaint. We urge the Court to take this opportunity to apply the principle of *Aldinger* to ancillary jurisdiction cases.

Conclusion

We submit that these issues are of importance and worthy of this Court's attention. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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